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C O N F I D E N T I A L SECTION 01 OF 03 KYIV 001910

SIPDIS

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TAGS: [EFIN](#) [EREL](#) [ECON](#) [PREL](#) [UP](#)
SUBJECT: GOU BROKE, NATIONAL BANK KEY TO UPCOMING GAS
PAYMENTS

REF: A. KYIV 421
[1](#)B. KYIV 955
[1](#)C. KYIV 1472
[1](#)D. KYIV 1487
[1](#)E. KYIV 1835
[1](#)F. KYIV 1888

Classified By: Economic Counselor Edward Kaska for Reasons 1.4 (b) and
(d)

[1](#)1. (C) Summary. Ukrainian government coffers are all but empty and Naftohaz is unlikely to be able to meet upcoming gas payment obligations without support from the National Bank of Ukraine (NBU). Analysts forecast that the government needs to find \$2.5 - \$3.75 billion to cover expenses for the rest of the year. This figure does not include gas payments, which will require \$1 - \$1.5 billion. To cover the gap, with the IMF program in question, analysts believe the NBU will eventually release funds for gas payments, and possibly for wages to teachers and doctors. NBU financing and government tightening would allow the GOU to muddle along for the next few months. However, Ukraine's grim budgetary situation only gets worse in 2010, and the economic and political consequences of just "muddling through" will be painful. End summary.

Glaring Budget Gap

[1](#)2. (C) The Ukrainian government needs \$2.5 - \$3.75 billion in the final months of 2009 to meet its budgetary obligations, according to Ildar Gazizullin, an economist at the local think tank International Center for Policy Studies. In addition, the newly signed social spending law (refs E and F) that would increase pensions and wages if implemented could add another \$337 million to the government deficit in [1](#)2009. Ukraine's efforts to combat the flu outbreak have also lead the Rada (Ukraine's parliament) to amend the 2009 budget and direct \$125 million to the Ministry of Health, despite the fact that the government's emergency reserve fund is broke. Taking into consideration all of these needs, Senior World Bank economist Pablo Saavedra estimates that Ukraine's requirements for the rest of the year amount to 2.5 - 3% of GDP, or approximately \$3 billion.

Gas Payments, External Obligations

[1](#)3. (C) Separately, Ukraine must make gas payments totaling between \$1-\$1.5 billion for the rest of the year to Russia. President Yushchenko's Envoy for Energy Security Bogdan Sokolovsky confirmed on November 4 that the November 7 gas payment (for gas received in October) would be \$470 million and that Naftohaz has approximately one-third, or \$150 million, of the required payment in working capital.

According to Sokolovsky, the Presidential Secretariat, the Cabinet of Ministers (CabMin), and Naftohaz were working together to find a solution to the payment problem. While Ukraine had asked Russia for some concessions, Sokolovsky said Russia seemed unwilling to be flexible on the terms of the payment. Sokolovsky also said that while Naftohaz still has on its books a portion of the UAH 18.6 billion (\$2.3 billion) in treasury bonds that the CabMin had provided over the summer to increase Naftohaz's statutory capital, there were few buyers for the bonds. In the end, the bonds would have to be sold to the NBU, but Sokolovsky predicted that the NBU would be reluctant to purchase the bonds. He commented that the NBU is already near its reserve limits as set by the IMF. Ukraine will need to pay Gazprom approximately \$500 million in December and a similar sum again in January (for December gas deliveries). Naftohaz's ability to pay will not improve by then, said Sokolovsky.

14. (C) Sokolovsky also lamented that if the IFIs had given Ukraine the \$1.7 billion in financing promised over the summer (ref C), Ukraine would not be having the current difficulties in making its gas payment. He added that the IFIs had been too firm on their conditions, including calling for a gas price increase, and would find themselves being pressured into giving Ukraine financing this winter when the situation worsens and gas transit to Europe is threatened.

15. (SBU) Ukraine reportedly has few other external debt payments due in the remainder of the year. Economists put the number at no more than \$300 million for interest and other payments for November and December combined. In addition, the recent Naftohaz Eurobond and bilateral debt

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restructurings (ref D) removed the need to cover any of these quasi-sovereign obligations for the rest of 2009.

IMF Program Off Track

15. (C) President Yushchenko's recent signing of the social spending law and Prime Minister Tymoshenko's proposed 2010 budget have both pushed Ukraine's negotiations with the IMF further off track. The 2010 budget as submitted already implied an 8% deficit, according to Saavedra at the World Bank, and needed to be revised to be more in line with the 4% the IMF and other IFIs could accept. In addition the World Bank estimates show that the social spending bill would add between 2.5% to 7.5% of GDP to the budget deficit in 2010, depending upon how the increases are indexed.

16. (C) Commenting on the political implications of the law, Independent Rada member Taras Chornovil told PolOff on November 3 that in his opinion Yushchenko gave Yanukovych an "amazing gift" when he signed the social welfare legislation into law. Overcoming the economic affects of the law, including the pressure it puts on the IMF program, would be detrimental for Tymoshenko. Deputy Head of the Presidential Secretariat Ihor Popov explained that he believes that the only reason Yushchenko signed the social welfare legislation was to damage Tymoshenko's presidential campaign. He said Tymoshenko would bear the brunt of public disaffection if the economy or exchange rate worsened in response to a delay in the IMF's fourth tranche. Party of Regions Rada Member Yuriy Miroshnichenko commented that the end of the IMF program would be the end of the Tymoshenko candidacy for president.

17. (C) IMF resident representative, Max Alier, said on October 3 that the IMF and the GOU are still negotiating a Letter of Intent (LOI), which would be the basis for the release of the next tranche of money. From the IMF representative's perspective, there are three essential elements for a LOI, as follows:

1A. Resubmission of the draft 2010 budget, bringing down the

fiscal deficit to 4% of GDP. However, the PM has declined to do this, instead promising to use administrative measures to bring spending into line with a 4% target.

¶B. Commitments regarding "incomes policy", meaning the GOU would oppose and the President would veto any legislation (like the recent pension/minimum wage law, plus whatever else the Rada might think up) that provides wage/ pension increases greater than inflation.

¶C. Signatures, demonstrating political commitment to the IMF program, preferably by all who originally bought into the program (President, Prime Minister, NBU, and Finance Ministry), but at least the NBU (central bank) and Finance Ministry, which the IMF has found minimally sufficient in some other countries.

Can Ukraine Make Its Gas Payments without the IMF?

¶8. (SBU) If IMF money does not come through in the near term, the NBU could participate in schemes that would allow its reserves to be used to make gas payments, as it has done in the past (refs A and B). However, the Bank, allied with President Yushchenko, has resisted monetizing government debts, including gas payments, in recent months as political tension between the President and the Prime Minister has mounted. Yushchenko's Deputy Chief of Staff Oleksandr Shlapak told the press that the president would not allow the 'QAb"zQg~I9GS-8QQ?QQ[\VgQgoods and services to continue to accrue if they chose to use the money for gas payments. However, since Naftohaz is able to collect only about \$100 - \$150 million in revenue each month from consumers, December's payment would be no easier to finance. Both the IMF and the World Bank believed that the government would not fund gas payments if it meant arrears to pensioners, teachers, or doctors.

Will the NBU Step In to Rescue the Government?

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¶9. (C) Local analysts believe there is enough pressure on President Yushchenko such that he will approve NBU financing of the gas payments for the rest of the year. The president would risk handing Tymoshenko the right to blame him and the NBU for a gas crisis if gas payment obligations are not met. Saavedra at the World Bank also expected the NBU to cover wage and pension payments as needed. He argued that Yushchenko understood that voters were unlikely to cast votes in his favor if they believed Yushchenko and the NBU were between them and their paychecks/ pensions.

Comment: Continued Economic Hardship

¶10. (C) Given the political nature of the decision, it is difficult to predict with any certainty whether and how much the National Bank will intervene to keep Ukraine's economy afloat. The timing of any such intervention could clearly have political implications for the presidential elections as well. Even with NBU intervention, Ukraine is facing continued economic hardship. The 2010 budget as submitted makes the economic situation even more unsustainable next year. One can expect that the biggest challenge for the next president will be how to deal with economic issues, including the continuing need to make gas payments, which are expected to increase, and an ever wider budget deficit in 2010. A new government might be able to approve some upward adjustments in gas prices for consumers relatively soon after coming into office; however, reform that arguably would have a more significant impact on the budget, such as pension reform, will be much more difficult and take longer to address. IFI lending could get the country through the elections, but the economic problems will remain. End Comment.

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